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Economic Forecast for 1980

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Business Report

Anyone who enjoys confusion would have a field day surveying the current economic scene. Not only did the economy exhibit surprising strength in the third quarter, but the Federal Reserve, in the process of tightening monetary policy, shifted its emphasis to limiting the growth of bank reserves and away from stabilizing money-market conditions, leaving interest rates to fluctuate widely. These steps were taken partly in response to speculation against the dollar that was developing in foreign exchange markets, implying that economic policymaking for the United States has been transferred in part from Washington to the money centers of Europe and Asia.

That's not all. Inflation continues to rage, in the process distorting those statistics denominated in dollars, from personal incomes to our trade balance. At the same time, it is becoming increasingly clear that the most common measure of inflation, the consumer price index, itself, is distorted because of the way it is assembled. Other unreliable economic statistics include the jobless figures, which continue to portray an inaccurate picture of the state of the labor market, and interest rates, which may be at record levels, but when viewed in the context of today's high rate of inflation, do not seem so high at all.

Turning to politics, there is the unprecedented admission of recession by an incumbent administration with its obvious attendant risks, election year politics and how they will interfere in the economic process, and, on the energy front, the decisions that will emanate from the Organization of Petroleum Exporting Countries regarding next year's supply and price of oil. Back home, there is the steep decline registered in the stock market during the month of October—on the 50th anniversary of the Great Crash—uncertainties over how much buying power people have left and whether they will continue to cut into savings or begin salting money away, how the banks will react as their supply of loanable funds declines in the face of continued demand, and whether the corporate sector will reach the condition of illiquidity experienced in the summer and fall of 1974, when businesses were forced to lay off two million people and dump inventories in response to a sudden lack of availability of short-term credit. Clearly, the forecaster's task is cut out for him.

Many economists have already reacted to these developments by marking down their economic numbers for the balance of this year and for 1980. Most now believe that the economy resumed its slide during 1979's fourth quarter and will continue falling in the first quarter of 1980. If they are correct, this would produce a recession that spans four calendar quarters—just about equal to the average contraction encountered since the end of World War II. They see the magnitude of the decline from 1979's first quarter to 1980's first quarter amounting to between two and three per cent. Again, this would be in the range of the typical decline in the real GNP, which has averaged 2½ per cent.

An Energy Spasm?

Not everyone holds to this comparatively sanguine view. There are a number of economists who believe that the recession first got underway during 1979's fourth quarter. They maintain that the decline in the second quarter of 1979 was an "energy spasm" and that the rise in the third quarter's real GNP which, according to the government's preliminary estimates, made up the entire drop in the second quarter, proves it. Because of this belief, they look for the U.S. economy to decline during most, if not all of 1980—with obvious negative consequences for unemployment, sales and earnings, and positive implications for inflation and interest rates. However, since 1980 is a presidential election year, it is conceivable that such a dreary scenario could result in massive government stimulus to get the economy moving again. If this were to happen, the longer run outlook for inflation could be quite bad.

I don't think we have to worry about this. I firmly believe that what happened in the second quarter of 1979 was not an energy spasm, but the beginnings of a downturn in the U.S. economy that would have occurred even in the absence of the gasoline crunch. The way I look at the third quarter figures, the fact that the real GNP was no higher than in the first quarter indicates that the economy clearly lost its forward momentum toward the end of last winter—as I had long expected it would. Furthermore, it is not unprecedented for the economy to brighten in the middle of a recession. In other words—no cyclical decline has consisted of a straight-line drop in the real GNP. The rates of decline have varied—and there was even one recession (occurring in 1970), where the real GNP, after falling in the first quarter, rose in the second and third before dropping in the fourth.

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Getting back to the current experience, just about everybody agrees that the economy will resume its slide during the current quarter. This is because of the continuing impact of inflation on people's buying power —including the yet-to-be-felt impact of higher-priced heating oil on homeowners' budgets. Also expected but not yet felt are the effects of the Federal Reserve's recent credit tightening moves on those industries that depend heavily on credit. Plainly, housing starts, which had been a bright spot in the economy until recently, are likely to tumble more than they usually do over the winter months because the supply of mortgage credit is dwindling rapidly.

Needless to say, a reduced level of housing starts would affect a variety of industries, since residential construction bulks so large in the U.S. economy. Industries ranging from lumber and plywood to carpeting, furniture and home appliances will experience declining sales during the coming year. The extent to which they lay off their employees thus adding to the national jobless totals, will depend on how well they have prepared for this decline—meaning, of course, whether they are stuck with inventories that are burdensome, in view of the cost of carrying these unsold goods.

Another major user of credit, the automobile industry, seems headed for additional sales declines on the heels of its troubles earlier this year. After running at a 9.3 million unit selling rate during the three calendar quarters ending first-quarter 1979, new domestic car sales dropped to an 8.4 million unit pace during the second and third quarters of this year. They are likely to fall further during the fourth quarter of 1979 and the first two quarters of 1980, averaging an 8 million unit clip at best. This would reflect not only Detroit's inability to provide the model mix to suit consumers' tastes but also, the tightened credit standards that lenders will employ in the wake of the Fed's monetary policy moves, as well as the general rise in joblessness which always impacts the domestic auto industry. I don't see auto sales improving until these three major depressants are alleviated—which might not come until next spring.

Of course, the question is not whether the economy will decline in the current quarter or even in the first quarter of 1980. Rather, the question seems to be whether the economy will come out of it around the end of 1980's first quarter, or will continue to sink further. Uncertainties mentioned above notwithstanding, I continue to feel that the recession will end sooner rather than later. In the previous issue of this Business Report, I pointed to such positive elements in the economy as the high level of employment, the continued strength in capital spending, the booming export sector, as well as the fact that this slowdown was widely anticipated, thus causing businessmen to be very watchful that their inventories not get significantly out of line with sales. I think these still apply today, but I would add another, which, ironically, is based on one of the developments that some economists would consider a negative: the Federal Reserve's changed method of conducting monetary policy.

The Fed's New Policy Is a Plus

It may be true that money-market interest rates are more volatile today than ever before, thus creating a great deal of uncertainty in the minds of bank lending officers, money traders, as well as corporate treasurers concerning the price and availability of short-term credit along with the opportunities for investing idle funds. However, money-market conditions should soon stabilize as participants (including the Fed, itself) adjust to the new rules of the game. As the Fed gains experience in managing the supply of bank reserves, its moves will be more predictable to money-market analysts who, in turn, will be better able to deal with these interest rate fluctuations, with the possible result that these oscillations might dampen. Even more significant, the fact that the Federal Reserve has finally decided to emphasize bank reserves as opposed to seeking to achieve a stable interest rate in the Federal funds market should result in a lowering in both the rate of inflation and interest—perhaps even sooner than might otherwise have been the case under its old method of pegging the Federal funds rate.

However, it remains to be seen whether the Fed pursues this new policy with the conviction necessary to deflate inflation expectations. Writing in a recent Federal Reserve Bulletin, Fed Governor Henry C. Wallich points out that "the Federal Reserve has found it difficult to exert close short-run control over M-1 and M-2 (the money supply) without risking unwanted side-effects on interest rates. In addition, relationships between the monetary targets and the ultimate objectives of policy have proved to be substantially less predictable than desired." Governor Wallich goes on to say that even if the Fed could accurately forecast the currency and deposit mix the public is likely to demand, hence the reserve growth necessary to accommodate some specified expansion in the money supply, it would be "reluctant to force the financial system to conform to this rigid pattern. Demands for money tend to vary considerably in the short run due to institutional considerations that are often not very responsive to short-term changes in interest rates; thus a rigid Federal Reserve commitment simply to supply the reserves its projections of the deposit mix showed would be needed for a desired rate of growth in money could be expected to produce marked short-run fluctuations in market interest rates." According to Governor Wallich, the Fed believes that the short-run volatility in market interest rates likely to result from such a policy would risk greater disruption of the economy than the short-run instability in money growth rates the policy was seeking to avoid.

In my opinion, the Fed's job of managing bank reserves in order that it might concentrate on stabilizing money growth rather than stabilizing money market conditions would be facilitated if the Federal government's bor-

rowing needs were reduced. As I pointed out more than a year ago (Business Report—Summer, 1978), the Fed's ability to slow the pace of money creation is limited by the absence of the correct fiscal policy. As long as Washington continues to run large and continuous budget deficits, any effort by the Federal Reserve to slow the rate of money growth to a non-inflationary pace would result in rapidly rising interest rates and eventually a severe credit squeeze. The reasons for this are not hard to discern. When the Federal government runs a deficit in its budget, it must borrow money to make ends meet. The more the government needs, the less is available for borrowers from the private sector—unless the Federal Reserve steps up the money creation process.

Since the Fed has done just this, it is possible to conclude that, although theoretically independent of the Executive and the Legislature, the nation's central bank is every bit as subservient to them as its counterpart in England and most other countries. The proof of this is the good correlation that exists between growth in Federal debt since the end of World War II and growth in the money supply. Unfortunately for our efforts to achieve stable prices there is an equally good relationship between growth in the money supply and the rate of price inflation.

In this connection, I note with interest the continued statements on the part of high Administration officials as well as members of the Congress that no early tax cut and/or spending increase is on the drawing boards. This tells me that our elected officials continue to place top priority on bringing the Federal budget into balance. Plainly, a balanced budget would take pressure off the Fed to expand the supply of money and credit beyond the economy's actual needs. And since the Fed has already indicated that it plans to pay close attention to the supply of credit rather than its price, it is possible to say that for the first time in a long while, both the fiscal and the money managers have finally embarked upon a coordinated attempt to slow inflation. More than anything else, this makes me optimistic—not only over the near-term course of the economy, but over the longer term as well. If the expectation of the inflation can be moderated, one major economic problem will be eliminated—speculation. The speculation that developed over the summer in the precious metals markets began to spill over into other commodities and threatened a new round of stockpiling of materials and supplies in the expectation that their price could only go in one direction: up.

Inflation-Fighting Remains Important

Reduced inflation expectations would also give the dollar a needed lift in foreign exchange markets. If economists have learned one thing during our 6½-year experiment with floating foreign exchange rates, it is that currency values are unpredictable day by day, but in the longer run, tend to reflect comparative rates of inflation. In other words—the quickest (and I might add, the only permanent) way to boost the value of the dollar in foreign exchange markets is to convince participants in these markets that the dollar will lose value less rapidly than other currencies. Needless to say, this would lead to a greater willingness on the part of people to hold dollars—and might induce OPEC to stabilize the price of oil. A strong dollar would also help further reduce inflation in this country, since it would slow—if not eliminate—the rise in prices of imported goods. Not only do higher-priced imports, themselves, add to domestic inflation, but in many cases, they provide an umbrella under which producers of domestic goods raise their prices, too.

The U.S. financial markets would benefit from a reduction in inflation expectations. As inflation expectations abate, it would be reasonable to expect long-term interest rates to fall, thus bond prices to rise. And after interest rates have fallen enough to make equities attractive relative to fixed-income investments, the stock market should go up. This latter development would help us get out of recession, too, by improving confidence of the "man on the street," as well as by providing another avenue for business to raise long-term capital.

Of course, for inflation expectations to diminish for more than just a short period of time, there must be results in the price indexes. These results might be long in coming, if the consumer price index continues to be regarded as the only indicator that people accept as the measurement of inflation. Because the CPI uses fixed weights in establishing consumption patterns, and because it takes into account only today's prices and interest rates in determining the cost of homeownership, the CPI overstates the ongoing rate of inflation by a considerable amount. How much can be determined by an examination of another price index which is not as widely followed—the gross national product price deflator for personal consumption expenditures. This index has shifting weights to reflect changing patterns of consumption as they occur, and it takes a more realistic measure of the cost of homeownership by using average, rather than new prices and interest rates. In the first nine months of 1979, the GNP price index for consumer spending rose at a 10 per cent annual rate. At the same time, the CPI climbed at a 13½ per cent clip. Besides prolonging inflation and the expectation of inflation, the consumer price index could very well prolong the recession by keeping monetary and fiscal policy tighter than need be the case.

With these statistical uncertainties added to policy uncertainties, the reader might think it presumptuous of me not only to forecast a sanguine outlook for 1980, but to quantify it numerically as the table on the back page indicates. However, I feel it is possible to forecast—and to be optimistic, at that—because our nation's economic policymakers have finally begun to pay more than lip service to the notion that inflation is Public Enemy Number One, and must be licked whatever the cost. Now if only 1980 were not an election year.

Autumn, 1979

MHT FORECAST OF GROSS NATIONAL PRODUCT

(Seasonally Adjusted Annual Rates)

In $ Billions

	YEAR 1978		< ACTUAL 1979			PROJECTED >	YEAR 1979		1980				YEAR 1980	
	LEVEL	% CH	I	II	III	IV	LEVEL	% CH	I	II	III	IV	LEVEL	% CH
Gross National Product	2127.6	12.0	2292.1	2329.8	2391.5	2421.7	2358.8	10.9	2448.9	2501.5	2555.5	2613.4	2529.8	7.3
GNP: $72	1399.2	4.4	1430.6	1422.3	1430.8	1423.2	1426.7	2.0	1415.5	1422.5	1431.3	1441.7	1427.8	0.1
% Change, Annual Rates	4.4		1.1	−2.3	2.4	−2.1	2.0		−2.1	2.0	2.5	2.9	0.1	
Consumption	1350.8	11.6	1454.2	1475.9	1528.6	1546.7	1501.3	11.1	1585.6	1635.6	1666.6	1695.7	1645.9	9.6
Durables	200.3	12.0	213.8	208.7	213.7	210.4	211.6	5.7	210.8	216.5	221.5	229.5	219.6	3.8
Non-Durables	530.6	10.2	571.1	581.2	602.5	605.3	590.0	11.2	619.9	633.0	648.9	665.1	641.7	8.8
Services	619.8	12.7	669.3	686.0	712.4	731.0	699.7	12.9	754.9	786.1	796.1	801.1	784.6	12.1
Investment	351.5	15.9	373.8	395.4	392.1	386.1	386.8	10.1	364.0	353.3	364.7	381.8	365.9	−5.4
Non-Residential	221.1	16.7	243.4	249.1	257.2	259.4	252.3	14.1	262.2	261.4	263.6	268.0	263.8	4.6
Producers Durable Equip.	144.6	14.1	158.5	158.6	162.6	164.1	160.9	11.3	166.2	166.2	168.1	170.1	167.6	4.2
Structures	76.5	22.2	84.9	90.5	94.6	95.3	91.3	19.3	96.0	95.2	95.5	97.9	96.1	5.3
Residential	108.0	17.5	111.2	112.9	114.9	112.6	112.9	4.5	103.2	83.9	85.8	100.0	93.2	−17.4
Inventory Changes	22.3		18.1	33.4	20.0	14.0	21.6		−1.3	8.0	15.2	13.8	8.9	
Net Exports	−10.3		4.0	−8.1	−5.3	0.7	−2.2		0.9	3.2	4.3	2.2	2.6	
Government Purchases	435.6	9.9	460.1	466.6	476.2	488.3	472.8	8.5	498.3	509.5	520.0	533.8	515.4	9.0
Federal Defense	99.0	5.6	103.4	106.0	108.5	112.8	107.7	8.8	114.9	117.1	119.3	124.3	118.9	10.4
Federal Civilian	53.6	5.8	60.2	55.7	54.0	58.1	57.0	6.4	59.1	60.0	60.9	63.0	60.8	6.6
State & Local	283.0	12.4	296.5	304.9	313.7	317.4	308.1	8.9	324.4	332.3	339.8	346.4	335.7	9.0
Final Sales: $72	1385.2	4.4	1418.4	1404.1	1420.8	1415.4	1414.7	2.1	1416.4	1418.3	1423.4	1434.6	1423.2	0.6
% Change, Annual Rates	4.4		1.1	−4.0	4.8	−1.5	2.1		0.3	0.5	1.4	3.2	0.6	
GNP Price Index (1972=100)	152.0	7.3	160.2	163.8	167.1	170.2	165.3	8.8	173.0	175.8	178.5	181.3	177.2	7.2
% Change, Annual Rates	7.3		9.3	9.3	8.4	7.4	8.8		6.8	6.7	6.3	6.3	7.2	
Consumer Price Index (1967=100)	195.5	7.7	207.4	214.1	221.0	226.6	217.3	11.1	231.5	235.5	239.2	242.8	237.3	9.2
% Change, Annual Rates	7.7		11.1	13.6	13.5	10.4	11.1		9.1	7.1	6.5	6.1	9.2	
Total Personal Income	1717.4	12.1	1852.6	1892.5	1943.4	1910.8	1899.8	10.6	1991.9	2057.1	2116.0	2167.8	2083.2	9.7
Disposable Personal Income	1458.4	11.7	1572.2	1601.7	1636.9	1621.8	1608.1	10.3	1684.2	1735.8	1785.5	1827.9	1758.3	9.3
Savings Rate	5.0		5.0	5.4	4.1	2.0	4.1		3.2	3.2	4.0	4.6	3.7	
Employment Rate	57.7		58.5	58.2	58.5	58.3	58.4		57.9	57.7	57.6	57.6	57.7	
Unemployment Rate	6.0		5.7	5.7	5.8	6.1	5.9		6.7	7.0	7.1	7.2	7.0	
Indus. Production (1967=100)	146.1	5.8	152.2	151.9	152.2	150.5	151.7	3.8	147.8	147.9	147.7	148.5	148.0	−2.4
Housing Starts (000)	2007.3	2.3	1615.3	1834.3	1825.0	1642.7	1729.3	−13.8	1234.0	1034.7	1231.4	1697.3	1299.3	−24.9
Domestic Auto Sales (000)	9300.0	2.0	9333.3	8033.3	8633.3	7990.1	8497.5	−8.6	7989.4	8338.1	8540.9	8550.1	8354.6	−1.7
Corporate Pre-Tax Profits	206.0	16.3	233.3	227.9	243.5	303.2	252.0	22.3	242.5	228.3	225.6	227.6	231.0	−8.3
− Taxes	84.5	16.4	91.3	88.7	95.3	119.5	98.7	16.8	95.3	89.8	88.7	89.6	90.8	−8.0
Net Profits	121.5	16.3	142.0	139.3	148.2	183.6	153.3	26.2	147.2	138.6	136.9	138.1	140.2	−8.5
− Dividend Payments	47.1	12.0	51.5	52.3	52.8	54.1	52.7	11.7	56.0	57.8	59.3	60.6	58.4	10.9
Undistributed Profits	74.3	19.2	90.5	87.0	95.4	129.5	100.6	35.3	91.2	80.8	77.6	77.5	81.8	−18.7
+ Depreciation	119.8	9.6	125.4	130.4	132.5	135.1	130.8	9.2	137.7	140.4	143.2	146.0	141.8	8.4
− Inventory Profits	25.2	66.6	39.9	36.6	40.8	33.1	37.6	49.2	28.7	27.7	31.6	35.3	30.8	−18.1
Net Cash Flow	168.9	7.9	176.0	180.8	187.1	231.5	193.9	14.8	200.2	193.6	189.2	188.2	192.8	−0.6

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Quarterly Business Conditions Analysis

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FIRST QUARTER 1980
Business Report

The rise in the economy during the fourth quarter of 1979 could very well lead many to conclude that the most widely heralded recession in history failed to appear as scheduled. It may indeed turn out to be this way, but I would not bet on it. I would still maintain that, when the dust settles and all the economic statistics are assembled and revised about as much as they are going to be, the umpire of the business cycle, the National Bureau of Economic Research, may very well declare that a recession did begin in 1979.

To be sure, this is not a consensus view. After all, whoever heard of a recession occurring while the real GNP was still climbing? Let me point out right at the outset that, while it is not common for the real GNP to rise during a recession, it is not unprecedented, either. In 1970, the real GNP fell in the first quarter, rose in the second and third before falling in the fourth. The NBER declared that entire year a recession!

The Bureau has not yet said anything about the 1979 experience except that it was a year of slowdown. This is a more significant judgment than meets the eye, since a slowdown is a necessary first step toward a recession. Between the end of World War II and the beginning of 1979, the U.S. economy experienced nine other periods in which economic growth slowed markedly. Six of these turned into recessions, while the other three did not. In other words—all postwar recessions have been preceded by a slowing of economic growth, although not all slowdowns have led to recessions.

When you consider where the current experience stands vis-a-vis the slowdowns and recessions, you can see why the National Bureau is having great difficulty in deciding just exactly what to call it. For you see, the economy in 1979 walked a fine line between slowdown and recession. After rising at an annual rate of 1.1 per cent in the first quarter, the economy in real terms fell by 2.3 per cent in the second. The increase of 3.1 per cent in the third and 1.4 per cent in the fourth barely makes up for the second quarter's decline: In the last three quarters of 1979 the real GNP averaged $1,431.3 billion—virtually unchanged from the $1,430.6 billion of the first quarter. Year over year, fourth-quarter 1979's real GNP was up only 0.8 per cent.

When compared with the three postwar slowdowns that did not develop into recessions and the six that did, this performance is about midway. In other words—1979's pattern was weaker than the path traced by the three postwar slowdowns—but stronger than the trail blazed by the six recessions. The key to determining what happens to this tenth postwar slowdown lies in an analysis of why the impact of the recession was not as severe in 1979 as many thought, as well as an assessment of the current scene.

Reasons For Buoyancy

As I see it, there are three major reasons why the economy failed to drop as much as expected in 1979. The first one that comes to mind is the advance warning given by economists that 1979 would be a year of difficulty. This Business Report, for one, warned toward the end of 1977 that "the prognosis for 1979 has turned decidedly dim." By the middle of 1978, the expectation that 1979 would be a poor year became widespread enough to rate major stories in several business news magazines. By autumn of that year, a majority of business forecasters were expecting a recession to begin sometime in 1979.

Plainly, such advance warning did not go unnoticed by the business community. With memories of the 1973-75 recession still fresh in their minds, businessmen took steps in 1978 to avoid a repetition of the inventory boom and bust that proved to be very costly in the previous business cycle. A close watch was kept on inventories, receivables, and other aspects of business operations that could prove to be troublesome in the event of declining economic activity. As a result, inventories remained fairly lean in most lines of business (with the exception of automobiles—a special case), thus obviating the need for widespread liquidation and massive layoffs of workers such as occurred beginning in September, 1974. Rather than rising as might be expected toward the end of a boom and the beginning of a recession, the inventory-sales ratio remained low. Adjusted for inflation, the I-S ratio for manufacturing and trade averaged 1.6 in 1979, only slightly higher than the 1.57 average of the previous two years. By contrast, this deflated ratio of inventories to sales peaked at 1.75 in the 1973-75 recession as well as in the 1970 recession. It hit 1.68 during the 1957-58 recession, and 1.63 during the 1960-61 recession.

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But this is only part of the story. An even more significant factor than the lack of weakness due to inventory work-downs was the continued strength of consumer spending. This occurred at a time when a slowing in the pace of outlays might ordinarily have been expected because of the flareup in inflation. In the past, when prices would begin to rise rapidly, people would respond by pulling in their horns, and refusing to buy those items whose prices were being rapidly marked up. Either they figured that they couldn't afford to pay the higher price, that the items weren't worth the higher price, or that the general acceleration of inflation would soon produce a recession, along with rising unemployment, which could affect them personally.

Needless to say, people reacted differently, this time around. Rather than slowing their pace of spending as inflation worsened, most consumers actually speeded it up. In other words—attitudes toward inflation changed significantly. People evidently figured that the way to cope with inflation is to buy sooner, rather than later. This was based on the very logical supposition that goods not purchased immediately, in a period of rising prices, would likely cost more later on.

Since inflation was rapidly draining the purchasing power of current income, people were able to lift their outlays by adapting one or more of several strategies. First, more sought—and obtained—employment. The rise in the number of job-holders from the low of 85 million reached just at the conclusion of the 1973-75 recession, 13 million or 15½ per cent, is unprecedented in economic history. As a result, the percentage of the working-age population holding a job rose from 55 per cent in the spring of 1975 to 59½ per cent by yearend 1979—also a record.

The source of these employment gains tells the story of the average family's ability to cope with inflation. While the percentage of men in the labor force has held fairly constant at about 80 per cent, the percentage of teenagers in the labor force rose from 55 per cent to 60 per cent, while the percentage of women in the labor force went up from 47 per cent to 52 per cent. What these percentages tell us, of course, is that the average family now has at least two people working, if not more. Indeed, nearly three-fifths of all households are in this multiple breadwinner category.

Plainly, this process could continue for quite some time, and if it does, it will permit people to keep lifting their outlays, and the economy to avoid recession. Even if it stops, however, and employment possibilities are no longer as good as they were in 1979, consumers might still be able to keep spending strong as long as they can borrow money or cut into their savings.

Again, there seems to be a change in attitudes toward use of debt and savings in a period of high inflation. In the past, when people sensed that prices were going up rapidly, they would cut down on their use of debt and try to increase their savings to, among other things, prepare for hard times. Since the last recession, however, people's attitudes have appeared to have undergone a 180-degree shift. As expectations of inflation mounted, people tended to borrow more readily and were more willing to deplete their savings balances. In this instance, people apparently felt that, not only was it worthwhile to buy goods before their prices went up, but if they were able to do so with borrowed money, which is paid back in cheaper dollars, and which incurs an interest obligation that is tax deductible, they were even better off. Part of this was the realization by many homeowners that the increase in equity in their homes because of rapid inflation of housing prices also presents a potential source of buying power.

Another reason why the economy still had strength in 1979 is the export sector. This may seem odd, considering the unbroken string of deficits registered in our merchandise trade balance since the beginning of 1976. However, exports are stronger than these deficits would indicate. In large part, these deficits have been caused by the rapid run-up in oil prices. Looking at the real volume of goods coming into and leaving this country (including oil) one finds a trade surplus that has been in existence since early 1978. It is also possible to discern a trade surplus in current dollars, if one removes oil entirely from our trade picture.

What this all means is that our trade deficit is largely a one-commodity phenomenon. In most industries U.S. businessmen are exporting more than they are importing. Since businessmen have strong overseas markets to offset whatever slowing develops domestically, they do not have to cut inventories, and can keep payroll levels high—in the process keeping the economy out of recession.

Recession Still Expected

Much as I would like to stop here and declare that the long-anticipated recession of 1979 turned out to be nothing worse than the fourth postwar slowdown, I cannot. I think that, for reasons I will list below, the economy will resume its slide in the current quarter and will fall again in the second. This should be enough evidence for the National Bureau to declare that the nation's seventh postwar recession did, indeed, occur.

I look for the economy to decline because I cannot see how the process of more people finding jobs, cutting into their savings and stepping up their use of debt to offset an inflation which is linked in part to their increased job prospects can continue for much longer. For one thing, prices of basic necessities (food, energy, shelter, and medical care) are rising faster than prices of nonessentials. Since people have to buy these necessities, by definition, the more they pay for essentials, the less they have left over for such nonessentials as big-ticket consumer durable goods. This is one reason why new domestic car sales have been falling. Peaking in the first quarter of 1979 at an annual rate of 9.3 million units, new domestic auto-

mobile sales in the ensuing six months fell to an 8.3 million unit clip. In the fourth quarter of 1979 sales fell further to a 7½ million unit pace—the lowest quarterly rate since midyear 1975.

Housing is another area that has been taking it on the chin for quite some time. After averaging a two million unit clip in 1977 and 1978, the pace of new housing starts dropped to a 1.7 million unit rate in 1979—ending up the year at a 1.5 million unit pace, 25 per cent lower than 1978. Further declines in homebulding seem likely, since the Commerce Department recently reported that sales of newly built single-family homes plunged by 13.5 per cent—the sharpest one-month drop in nearly a decade.

The behavior of these two key industries should not be overlooked as a clue to what is likely to happen this year. There never has been a time when housing and autos were falling that the U.S. economy managed to escape recession. It is easy to see why. Those industries that sell to the housing market either before, during, or after the construction phase, are widespread —and are suffering. The drop in the demand for lumber has already caused spot prices of lumber to plunge some 40 per cent. On the other end, the home furnishings market appears to be softening. For its part, the weakness in automobiles sales has already spread to rubber and steel. Production of tires is down 11½ per cent from the previous year's levels while total steel shipments are off as well.

Since these industries tend to be concentrated in certain parts of the country, it is clear that business conditions in these parts will suffer. This would seem to make it difficult for other members of families affected by layoffs to find work to offset the income from the job loser. And, of course, if there already had been two or more people at work and one loses a job, whatever additional debt they took on or funds they removed from their savings account will only complicate matters more.

This brings me to another reason to expect less consumer spending: the abnormally low savings rate. Savings as a percentage of take-home pay averaged 3.3 per cent in 1979's fourth quarter—one of the lowest rates in the past 30 years, and exactly half the average savings rate of the 1970s. Clearly, a rate this far below normal increases the probability that it can't go down much further, if at all. A cessation of the decline in the savings rate during the current quarter would remove $16 billion from the spending stream—an amount equal to one-third of the fourth quarter's rise in personal consumption expenditures.

As for debt, it is high no matter how you slice it. The percentage of personal incomes that people must earmark to payoff installment credit, 15½ per cent, is the highest in recent memory and well above the long-run average of 13½ per cent. Total consumer credit outstanding as a percentage of disposable income, 18 per cent, is also at a record high. As with savings, each new record high in use of debt reduces the probability that it could go up any further.

Another reason to expect to less spending, hence a decline in the economy, is the trend in buying power (income growth minus the rise in prices). At year-end, the annual rise in prices had outstripped the annual rise in personal incomes by nearly two percentage points. The last time buying power fell this much on an annual basis was during the 1973-75 recession. Even worse is the fact that a lot of this loss in buying power is being transferred overseas to the oil-exporting countries, thus producing a decline in living standards for the United States as a whole.

The effects of these trends are visible in the behavior of the government's index of leading economic indicators. Comprised of 12 statistics that tend to foreshadow future economic developments, this index hit a high point for the current cycle in October, 1978, and has since declined by over four per cent. It stands closer to the average of the path traced by the six postwar recessions than to the average of the three postwar slowdowns. Another index, the ratio of those indicators that measure current activity to those that lagged behind, stands well below the path of the six postwar recessions, is falling as fast as it did prior to and during the 1973-75 recession—and is at its lowest point in the postwar era.

A Weak Recovery

Having said all this, I believe that, while the recession may very well turn out to equal 1973-75 in length, the magnitude of the decline should be much less. Still, the recession should have the usual effect on inflation, interest rates, the stock market, the dollar, and our balance of trade. I have discussed these in previous issues of this Business Report.

As for the post-recession outlook, the one thing that can be said at this point is that the recovery—whenever it begins—will be weak. This would contrast with the typical post-recession snapback in economic activity. The mild recovery should result from continued high rates of inflation, economic policies that remain restrictive in order to combat it, the continued transfer of buying power from this country to the oil-exporting nations, and inadequate capacity to handle a surge in sales. The sooner our tax laws are changed to encourage capital investment, the faster the economy will grow, since increased capital spending will not only boost capacity—it will help lower the inflation rate by improving productivity. Needless to say, the right energy policy would have to follow as well, in order to end the transfer of buying power to the oil-exporting countries. In my opinion, this would be accomplished best if the Government would get out of the business of pricing and allocating energy and let the marketplace do the job.

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FEB 20 1980

First Quarter 1980

MHT FORECAST OF GROSS NATIONAL PRODUCT

(Seasonally Adjusted Annual Rates)

In $ Billions

	YEAR 1978		1979				< ACTUAL YEAR 1979		PROJECTED > 1980				YEAR 1980	
	LEVEL	% CH	I	II	III	IV	LEVEL	% CH	I	II	III	IV	LEVEL	% CH
Gross National Product	2127.6	12.0	2292.1	2329.8	2396.5	2455.8	2368.6	11.3	2508.3	2543.5	2596.7	2658.9	2576.9	8.8
GNP: $72	1399.2	4.4	1430.6	1422.3	1433.3	1438.4	1431.2	2.3	1431.1	1422.5	1430.2	1439.2	1430.7	0.0
% Change, Annual Rates	4.4		1.1	−2.3	3.1	1.4	2.3		−2.0	−2.4	2.2	2.5	0.0	
Consumption	1350.8	11.6	1454.2	1475.9	1528.6	1580.4	1509.8	11.8	1613.6	1663.8	1696.7	1725.9	1675.0	10.9
Durables	200.3	12.0	213.8	208.7	213.4	215.5	212.8	6.3	214.2	218.7	223.6	229.1	221.4	4.0
Non-Durables	530.6	10.2	571.1	581.2	604.7	631.0	597.0	12.5	645.8	663.1	677.7	691.3	669.4	12.1
Services	619.8	12.7	669.3	686.0	710.6	733.9	700.0	12.9	753.6	782.0	795.4	805.4	784.1	12.0
Investment	351.5	15.9	373.8	395.4	392.3	383.3	386.2	9.9	386.8	365.2	376.8	394.3	380.8	−1.4
Non-Residential	221.1	16.7	243.4	249.1	261.8	261.3	253.9	14.8	267.0	266.8	269.5	274.6	269.4	6.1
Producers Durable Equipment	144.6	14.1	158.5	158.6	166.7	162.6	161.6	11.8	167.8	167.4	169.6	172.2	169.2	4.7
Structures	76.5	22.2	84.9	90.5	95.0	98.7	92.3	20.6	99.2	99.4	99.9	102.4	100.2	8.6
Residential	108.0	17.5	111.2	112.9	116.0	115.6	113.9	5.5	116.4	96.2	93.4	105.2	102.8	−9.8
Inventory Changes	22.3		19.1	33.4	14.5	6.4	18.4		3.5	2.1	13.9	14.5	8.5	
Net Exports	−10.3		4.0	−8.1	−2.3	−7.7	−3.5		−1.7	−2.6	−4.4	−3.0	−2.9	
Government Purchases	435.6	9.9	460.1	466.6	477.8	499.8	476.1	9.3	509.6	517.1	527.6	541.7	524.0	10.1
Federal Defense	99.0	5.6	103.4	106.0	109.0	114.6	108.3	9.3	117.4	120.0	123.7	129.0	122.5	13.2
Federal Civilian	53.6	5.8	60.2	55.7	53.9	62.4	58.1	8.3	65.3	63.0	63.0	66.0	64.3	10.8
State & Local	283.0	12.4	296.5	304.9	314.9	322.8	309.8	9.5	327.0	334.1	340.9	346.7	337.2	8.8
Final Sales: $72	1385.2	4.4	1418.4	1404.1	1426.2	1435.2	1421.0	2.6	1431.0	1422.5	1423.6	1431.8	1427.2	0.4
% Change, Annual Rates	4.4		1.1	−4.0	6.4	2.5	2.6		−1.2	−2.3	0.3	2.3	0.4	
GNP Price Index (1972 = 100)	152.0	7.3	160.2	163.8	167.2	170.7	165.5	8.9	175.3	178.8	181.6	184.8	180.1	8.8
% Change, Annual Rates	7.3		9.3	9.3	8.5	8.7	8.9		11.0	8.3	6.3	7.2	8.8	
PCE Deflator (1972 = 100)	149.9	6.8	157.8	161.3	165.1	169.0	163.3	8.9	174.4	178.6	181.6	184.5	179.8	10.1
% Change, Annual Rates	6.8		10.8	9.2	9.8	9.8	8.9		13.4	10.0	6.9	6.4	10.1	
Consumer Price Index (1967 = 100)	195.5	7.7	207.4	214.1	220.7	227.6	217.4	11.2	234.0	240.3	244.9	249.1	242.1	11.3
% Change, Annual Rates	7.7		11.1	13.6	12.9	13.1	11.2		12.0	11.1	8.0	7.1	11.3	
Total Personal Income	1717.4	12.1	1852.6	1892.5	1946.6	2000.5	1923.1	12.0	2052.0	2095.0	2143.2	2192.9	2120.8	10.3
Disposable Personal Income	1458.4	11.7	1572.2	1601.7	1640.0	1678.8	1623.2	11.3	1731.4	1768.3	1810.6	1851.3	1790.4	10.3
Savings Rate	5.0		5.0	5.4	4.3	3.3	4.5		4.3	3.4	3.8	4.3	3.9	
Employment Rate	57.6		58.4	58.1	58.4	58.4	58.3		58.3	58.1	57.9	57.8	58.0	
Unemployment Rate	6.0		5.7	5.8	5.8	5.9	5.8		6.2	6.5	6.9	7.1	6.7	
Indus. Production (1967 = 100)	146.1	5.8	152.2	151.9	152.3	152.1	152.1	4.1	150.9	147.8	147.8	149.9	149.1	−2.0
Housing Starts (000)	2007.3	2.3	1615.3	1834.3	1834.0	1604.3	1722.0	−14.2	1434.2	1038.5	1210.5	1684.3	1341.9	−22.1
Domestic Auto Sales (000)	9300.0	2.0	9333.3	8033.3	8633.3	7500.0	8375.0	−9.9	7721.5	7714.0	8027.5	8470.3	7983.3	−4.7
Corporate Pre-Tax Profits	206.0	16.3	233.3	227.9	242.3	244.4	237.0	15.0	240.6	230.4	240.8	249.2	240.2	1.4
− Taxes	84.5	16.4	91.3	88.7	94.0	95.0	92.3	9.2	93.3	89.3	93.4	96.7	93.2	1.0
Net Profits	121.5	16.3	142.0	139.3	148.3	149.4	144.7	19.1	147.3	141.1	147.4	152.5	147.1	1.6
− Dividend Payments	47.1	12.0	51.5	52.3	52.8	54.4	52.8	11.9	55.9	57.4	58.9	60.6	58.2	10.3
Undistributed Profits	74.3	19.2	90.5	87.0	95.5	95.0	92.0	23.7	91.4	83.7	88.5	91.9	88.9	−3.4
+ Depreciation	119.8	9.6	125.4	130.4	132.8	135.2	131.0	9.3	140.1	143.7	147.3	151.0	145.5	11.1
− Inventory Profits	25.2	66.6	39.9	36.6	44.0	46.9	41.9	66.1	52.2	46.8	43.3	40.6	45.7	9.2
Net Cash Flow	168.9	7.9	176.0	180.8	184.3	183.3	181.1	7.2	179.4	180.6	192.6	202.3	188.7	4.2

Quarterly Business Conditions Analysis

By IRWIN L. KELLNER
Senior Vice President and Economist

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SECOND QUARTER 1980
Business Report

For more than three years, the U.S. economy, like the proverbial prize fighter, has been bobbing and weaving in an effort to avoid the blow of recession. It came close to taking a fall in late 1976, when the growth rate of the real GNP decelerated sharply. However, the economy regained its strength, and the real GNP rose sharply during the first half of 1977. Toward the end of that year and into early 1978, the economy appeared to weaken once again but summoned reserve energy and bounced back in the second quarter of that year. In early 1979 the economy appeared to be going down for the count. The real GNP literally flattened in the first quarter and fell by an annual rate of nearly 2½ per cent in the second. Incredibly, however, the economy regained its stamina and continued to press on during the second half of last year and into early 1980.

Notwithstanding its valiant efforts to remain on its feet, the economy seems finally to have been delivered the knockout punch and is now slipping into recession. I say this, not only because of the messages being flashed by those statistics that measure the course of the current economy as well as those that tend to predict its near-term future, but also because the creation of a recession has now become official government policy. And the government has never failed to bring on a recession when it set out to do so.

Economic Policy Finally Tightens

Take fiscal policy, for example. The recently unveiled Federal budget for fiscal 1981 now envisions a surplus of $16.5 billion. If it turns out this way, this would represent a shift of nearly $60 billion compared with the estimated fiscal 1980 outcome. The Federal budget has shifted from deficit to surplus on four previous occasions during the past 30 years. On three of these occasions—fiscal years 1956, 1960 and 1969—the turnaround coincided closely with the advent of recession. Only in 1951, in the middle of the Korean conflict, did the shift from deficit (in fiscal 1950) to surplus in the following year not precede the onset of a recession.

The anticipated fiscal 1981 turnaround may well be even more restrictive than those of the past. First, the magnitude of the turnaround—both in absolute size ($60 billion) and in relation to constant dollar gross national product (4.0 per cent) will be the largest since 1950. Second, Federal tax receipts are expected to be equivalent to almost 22 per cent of gross national product in fiscal 1981, the highest percentage tax take in any of the turnaround years since 1950. In other words—fiscal policy has not only delivered a blow but a pretty hard one, at that.

As tight as fiscal policy might seem to have become, the knockout blow nonetheless has been delivered by monetary policy in the form of the sudden and severe tightening of credit by the Federal Reserve during the middle of March. Whereas fiscal restraint takes some time to work its effects on economic activity, monetary restraint tends to be felt overnight. This time around, the Fed has not only tightened up using such traditional levers of monetary policy as open market operations and changes in reserve requirements, it has intervened selectively in the origination and distribution of credit through the Credit Control Act of 1969. By telling the banks that their loan portfolios can grow no more than nine per cent between December 1979 and December 1980 at a time when loan volume was expanding at about a 20 per cent annual rate, the Fed has tightened monetary policy with unprecedented swiftness.

While the economic statistics will not show the effects of this one-two punch from fiscal and monetary policy until the current quarter, the data for the first quarter show that the economy was weakening, anyway. For example, after rising 0.3 per cent in January, the seasonally adjusted level of industrial production fell 0.2 per cent in February—and slumped a hefty 0.8 per cent in March. This decline matched a similar drop in August 1979 and was the sharpest since a plunge of 1.4 per cent last April. However, last April's drop reflected a nationwide trucking strike, while the August decline was centered mainly in the motor vehicle sector on the heels of last spring's shortage of gasoline. Spring 1980 finds supplies of motor gasoline standing at record levels.

The production declines are becoming quite pervasive. While output of business equipment was unchanged in March compared with February, production of consumer goods fell by a seasonally adjusted 0.8 per cent, with signficant reductions in output of both durable and nondurable goods. Reflecting cutbacks in gasoline, food and clothing, production of consumer softgoods

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declined 0.6 per cent. Output of consumer durable goods was reduced by 1.4 per cent, with declines in home goods and automotive products leading the way. Production of home goods—mainly appliances, carpeting and furniture—dropped 1.7 per cent in March, after almost as large a drop in February. March assemblies of autos were at an annual rate of 7.1 million units—down from February and nearly 25 per cent below a year ago.

Consumer Spending Down

These declines in output of consumer goods no doubt reflect a response to the sharp slowing in retail sales. After adjusting both for higher prices and normal seasonal variation, retail sales fell by an average of three per cent a month in February and March. Coming after a year of flatness, this drop takes the "real" level of retail sales down to their lowest level in 3½ years. Further declines would seem to be in store. For one thing, people's buying power is plunging sharply. The over-the-year drop in buying power (take-home pay adjusted for inflation) is greater than it has been since the 1973-75 recession. And with rising unemployment now holding back incomes, it seems likely that buying power will drop even faster in the months ahead.

People cannot turn to savings as a means of offsetting this drop in buying power. The savings rate, which hit a 30-year low of 3½ per cent of take-home pay in the fourth quarter of 1979, dropped further in the first quarter of 1980. People can't turn to credit, either, as a source of spending power, since credit usage had been so high that people voluntarily began to cut back their use of credit. Now even those who want to turn to debt will find it difficult because of the Federal Reserve's credit-tightening moves.

Another source of buying power for many people was the ongoing increases in the value of their homes. As a means of keeping pace with—or possibly trying to beat—inflation, many people discovered that they could tap this built-up equity either when they sold their home or through simply taking out a second mortgage. But the Fed's recent policy changes have produced sky-high mortgage interest rates, along with a significant reduction in the availability of mortgage funds. The combination of the two was enough to depress housing prices in many parts of the country thus closing off this avenue for consumers to spend.

Of course, the sharp cutback in mortgage funds has affected new-home construction. The rate of new home-building plummeted 22 per cent in March compared with February, taking normal seasonal changes into account. This was the largest monthly drop since 1960. The annual rate of new-home starts in March, 1.04 million units, was the lowest since the 1973-75 recession. Further declines would appear likely, since permits issued for new-home construction are falling rapidly. It is very possible that the annual rate of housing starts will drop below levels reached during the low points of the 1973-75 recession, as well as late in 1966.

With the economy now on its back, producers are striving valiantly to avoid another round of inventory accumulation. It may be too late. True, the quarterly data from the GNP accounts show only a modest change in business inventories. In the first quarter of 1980 business inventories grew at a $4.5 billion annual rate, down from the fourth quarter's $5.6 billion clip, and about one fifth of the pace recorded during the first three quarters of 1979. However, the GNP inventory data are notorious for their inaccuracy. For one thing, they are based on fragmentary information for the quarter. For another, because of the way the GNP accounts are put together, they are subject not only to the usual seasonal adjustments, but also to an adjustment that is supposed to remove the influence of higher prices on the change in the value of business inventories. Because the government is never really sure what percentage of reporting companies is on a first-in-first-out (FIFO) accounting basis, and how many are on last-in-first-out (LIFO), it tends to miscalculate changes in the value of business inventories—especially at business cycle turning points.

The monthly inventory statistics, which are subject only to seasonal adjustments, paint a much different picture. In February, for example, inventories rose 0.7 per cent—faster than the rate of increase in overall business sales. Since periods of rapid inflation tend to affect sales before they affect inventories—no matter what accounting method is used—it is likely that the "real" value of business inventories climbed even faster. Indeed, the Commerce Department calculates a so-called "real" ratio of inventories to sales. The latest reading of this measure shows that, while the current-dollar ratio of inventories to sales appears to be at one of its lowest points in recent years, in terms of actual units of goods unsold compared with units of sales, the I-S ratio has reached its highest point since the middle of the 1973-75 recession. What is more, it is well above the level that prevailed when that recession first began.

Weakness is certainly evident from the labor market statistics. Total employment dropped by 300,000 in March, putting the number of jobholders at the end of the first quarter only 48,000 above last November. By contrast, total employment rose by an average of 157,000 a month in the previous 12 months—and almost twice that much in 1978. The rise of 131,000 in the number of people unemployed puts this total at 6,438,000—the highest for any month in more than two years. In addition, there was an increase in the number of discouraged workers—people who are not looking for work because they believed they could not find any. Since late 1978 the number of discouraged workers had held at around 750,000. However, in the first quarter of this year, their number rose to one million.

The labor market is expected to weaken significantly in the coming months. For one thing, the average work week for nonsupervisory workers fell for the second straight month. A drop in hours worked is often an indicator of rising unemployment in the near future, since employers tend to cut back hours worked before they lay off their employees. Not surprisingly, the new-hire rate is down while the separation rate is rising. Finally, the Conference Board's measure of help-wanted advertising has fallen for three months in a row.

Other data show the weakening economy. Business failures are currently running at their highest rate since 1976. So far this year, reports Dun & Bradstreet, casualties are running 22 per cent above comparable 1979 levels. Another barometer of the state of the economy is prices of industrial raw materials. After climbing steadily throughout 1979—accelerating toward yearend—prices of industrial raw materials broke toward the end of February and have since retreated by seven per cent. Prices of key foodstuffs are falling even faster. Since peaking in mid-February, food commodities' prices have dropped more than 12 per cent, putting them at their lowest level in over two years. The drops in prices of such a wide variety of commodities as these clearly indicate that a change has taken place in the balance between supply and demand in the economy.

Needless to say, as bleak as this economic picture appears, it depicts the economy as it existed before the knockout blow delivered by the Federal Reserve in mid-March. As observed above, the impact on the economic statistics of the Fed's recent round of credit tightening will not show up until the second quarter, at the earliest. If weekly statistics are any guide, the data for the current quarter could be quite bad. After registering yearly gains averaging 3½ per cent through early March, production of paperboard—a commodity that is an excellent coincident indicator of the economy since it is used for packaging—has begun to decline. Output of steel has been declining since the beginning of this year, but the yearly percentage changes appear to be getting larger. Bituminous coal production, which had registered year-over-year gains as high as 21 per cent earlier this year, is now barely even with 1979. Needless to say, output of new cars and trucks is down considerably from year-ago levels, as is the production of lumber. Not surprisingly, there has been a sharp cutback in freight revenue ton miles for the nation's airlines, as well as in tonnage shipped by trucks.

In the face of this progressive and rapid weakening of the economy, the Commerce Department reported that the real GNP rose in the first quarter compared with the fourth. It would appear that this reflects the high base of January, which in turn, may have looked stronger than it actually was because of the unseasonably mild weather experienced this past winter. Since the past several Januaries have produced severe winter weather —either in the form of blizzards and/or extreme cold— the seasonal adjustment factors for the month, as well as for the first quarter, have been pulled down, in order to compensate for these weather developments. Thus it stands to reason that sales would look better than they really are even had this past winter been normal—much less mild, the way it turned out.

Seasonal adjustments notwithstanding, the economy seems likely to contract over the balance of 1980, and possibly into 1981 as well. As the table on the back indicates, I look for the real GNP to decline during the second, third and fourth quarters of 1980 by annual rates ranging from two to four per cent. As I said at the outset, I base this expectation on the tight posture assumed by monetary and fiscal policy, as well as because of the signals being flashed by the economic statistics that measure the ongoing course of economic activity.

As most of you know, there are statistics that have been assembled because of their ability to look ahead. This is the Commerce Department's index of leading economic indicators. As of February, this index had fallen for five consecutive months. There have been only two occasions since the end of World War II in which a decline in the leading economic indicators for five months did not signal the onset of a recession. Both of these instances were, however, somewhat exceptional, in that they occurred during wartime. The first occurred during 1951, in the middle of the Korean War, and the second took place during 1966 as the U.S. escalated its involvement in the Vietnam War. Since we are not at war at present, the five-month decline in this index should be regarded as an important sign that a recession is likely—if it has not already begun.

Debate Over Severity

The next question to consider is: How bad will the recession get? Until recently most economists had been expecting a comparatively mild recession. Their argument was that many of the distortions that caused the 1973-75 slump to be the worst in the postwar era do not exist this time around. For one thing, inventories appear to be in better shape now than in 1973-74, when warnings of recession were generally not as widespread as they have been this time. There isn't the speculation in homebuilding through the real estate investment trusts that existed the last time around. Capital spending plans remain firm and could provide important underpinning to any weakness in the consumer area. And the rise of the multi-income household would seem to make family buying power less subject to the ravages of unemployment, since if one family member loses his or her job, chances are one or more might still be at work.

Counterbalancing these "pluses" are some minuses. For one thing, the rate of inflation by whatever measure one chooses is clearly higher than in the last business

cycle and one of the worst, if not the worst, in the postwar era. Interest rates on many types of instruments reached record levels and on others, such as the banks' prime lending rate, reached levels not seen for 100 years or more. As I noted before, both fiscal and monetary policy have tightened to a degree unprecedented in modern times. What is more, the ability of the government to reverse field and stimulate economic activity should it appear that the downturn is getting out of hand is not the same as it was in past cycles. This is because the financial markets both here and abroad are extremely concerned about the present Administration's staying power when it comes to fighting inflation. If Washington eases up on fiscal and/or monetary policy at the first signs of economic pain while inflation continues to rage, the financial markets here and abroad will go through the wringer once again much the same way they did late last year and early in 1980. Such a renewed period of turmoil could shake the whole foundation of our international financial system—which has already been weakened significantly by previous bouts of inflation, high interest rates and a growing burden of debt.

On this subject, I would note that the international banking system is once again facing the problem of recycling petrodollars. The current OPEC surplus amounts to somewhere between $80 billion and $120 billion. This has caused international bankers some sleepless nights. For one thing, the amounts involved are much greater this time around. For another, the appetite of the participants for another infusion of developing country debt is probably much less. Not that economic conditions are any better in the developed world. Indeed, while the economies of Western Europe and Japan are still expanding, the fiscal and monetary brakes have been applied overseas, raising the possibility of another synchronized downturn as our trading partners slip into recession before we get out of ours.

Perhaps the biggest negative this time around as far as the U.S. economy is concerned is the consumer. Clearly overextended because of their stepped-up use of credit and cuts in savings, consumers are plainly more vulnerable to an economic downturn this time around than in the past. If rising unemployment strikes those families heavily saddled with debt, personal bankruptcies could soar, setting off a chain reaction in the process that would affect industries across the entire spectrum of consumer goods. It will take people many years to repair the damage done to their balance sheets by the "buy-in-advance" attitude that developed recently as a response to accelerating inflation. As noted above, the savings rate is bumping postwar lows. Buying power is falling faster than it has since the last recession, while the debt burden is at a record high relative to family incomes.

Compounding this is the possibility that the rise in unemployment this time around might be even swifter than in the past. As I have noted in several previous issues of this Business Report, the pace at which new jobs were created during the expansion that began in April 1975 was nothing short of phenomenal. This reflected a fortunate confluence of two elements: demand and supply. The supply of people willing to work was there because of the two- and three-income family alluded to earlier. The demand for workers matched supply because of the shift in the economy toward labor-intensive, low-productivity industries. If this recession is confined to the usual hardgoods industries, then layoffs will not be out of proportion to past history, since manufacturing productivity has continued to rise, and employment gains have not been out of the ordinary. But if this recession spreads across a whole host of consumer industries, as I think it will, then layoffs will occur in services, retailing and white-collar industries in general, where employment gains have been the greatest. It stands to reason that if it took more than the usual number of workers to increase output in a labor-intensive sector, it will take a layoff of more than the usual number of workers to decrease output if these sectors run into difficulty. And, I would remind you, that unlike past cycles, families won't have credit to turn to, since lending institutions have virtually shut off the credit tap in the wake of the Fed's mid-March policy tightening.

Of course, this lack of credit availability applies to corporations as well, and that is another reason why this downturn could be worse than average. As I said before, the Fed expects that total commercial and industrial loans will rise by not more than nine per cent in the 12 months ending December 1980. Clearly, it's going to take a lot of persuading to get bankers to dispense credit—no matter how pressing the need. And the need for credit usually intensifies during this phase of a business cycle when inventories pile up and receivables swell.

Conclusions

Where I come out is on the side of those who feel that the current recession will be at least as bad as the one experienced during 1973-75. That is—I look for the recession to run about four-five calendar quarters with a top-to-bottom decline in the real GNP of about three per cent. The exact length and depth of the recession will, of course, not only be determined by what lies ahead but by what the National Bureau of Economic Research, the umpire of the business cycle, says occurred retroactively. If their business cycle experts date this recession as having begun sometime in 1979, then the length of the current cycle could very well exceed the dimensions of the 1973-75 experience. However, even if the NBER says that the recession did not begin until early this year, it still appears severe enough to compare very closely with 1973-75.

Second Quarter 1980

MHT FORECAST OF GROSS NATIONAL PRODUCT

(Seasonally Adjusted Annual Rates)

In $ Billions

	< Actual				Projected >							
	1979		YEAR 1979		1980				YEAR 1980		1981	
	III	IV	LEVEL	% CH	I	II	III	IV	LEVEL	% CH	I	II
Gross National Product	2396.5	2456.9	**2368.8**	**11.3**	2520.3	2559.0	2597.2	2649.0	**2581.4**	**9.0**	2694.6	2743.0
GNP: $72	1433.3	1440.3	**1431.6**	**2.3**	1444.2	1429.4	1415.0	1407.9	**1424.1**	**−0.5**	1400.7	1400.8
% Change, Annual Rates	3.1	2.0	**2.3**		1.1	−4.0	−4.0	−2.0	**−0.5**		−2.0	0.0
Consumption	1528.6	1580.4	**1509.8**	**11.8**	1634.1	1671.1	1716.8	1756.4	**1694.6**	**12.2**	1784.0	1816.0
Durables	213.4	216.2	**213.0**	**6.4**	221.8	208.2	211.3	218.8	**215.0**	**0.9**	218.6	222.3
Non-Durables	604.7	630.7	**596.9**	**12.5**	653.0	677.7	699.9	715.9	**686.6**	**15.0**	729.7	743.4
Services	710.6	733.5	**699.9**	**12.9**	759.4	785.2	805.6	821.7	**793.0**	**13.3**	835.8	850.4
Investment	392.3	387.2	**387.2**	**10.1**	388.8	374.4	355.4	355.5	**368.5**	**−4.8**	361.3	368.4
Non-Residential	261.8	265.2	**254.9**	**15.3**	271.6	276.4	280.9	285.6	**278.6**	**9.3**	288.1	291.9
Producers Durable Equipment	166.7	165.0	**162.2**	**12.2**	169.0	172.1	175.7	179.3	**174.0**	**7.3**	182.0	185.5
Structures	95.0	100.2	**92.6**	**21.1**	102.6	104.3	105.2	106.3	**104.6**	**12.9**	106.1	106.4
Residential	116.0	116.4	**114.1**	**5.6**	112.7	92.9	78.0	76.0	**89.9**	**−21.2**	77.1	79.0
Inventory Changes	14.5	5.6	**18.1**		4.5	5.1	−3.5	−6.1	**0.0**		−3.9	−2.4
Net Exports	−2.3	−11.9	**−4.6**		−21.0	−14.0	−12.3	−15.4	**−15.7**		−17.3	−19.0
Government Purchases	477.8	501.2	**476.4**	**9.4**	518.3	527.5	537.2	552.5	**533.9**	**12.1**	566.6	577.6
Federal Defense	109.0	114.6	**108.3**	**9.3**	119.6	122.7	126.6	133.2	**125.5**	**15.9**	136.4	139.8
Federal Civilian	53.9	63.8	**58.4**	**9.0**	67.7	67.6	67.9	70.6	**68.4**	**17.2**	71.8	72.9
State & Local	314.9	322.8	**309.8**	**9.5**	331.0	337.3	342.8	348.7	**339.9**	**9.7**	358.4	364.8
Final Sales: $72	1426.2	1439.0	**1421.9**	**2.7**	1444.3	1427.3	1417.3	1411.1	**1425.0**	**0.2**	1402.8	1402.1
% Change, Annual Rates	6.4	3.6	**2.7**		1.5	−4.6	−2.8	−1.7	**0.2**		−2.3	−0.2
GNP Price Index (1972 = 100)	167.2	170.6	**165.5**	**8.9**	174.5	179.0	183.5	188.2	**181.3**	**9.6**	192.4	195.8
% Change, Annual Rates	8.5	8.3	**8.9**		9.5	10.7	10.5	10.4	**9.6**		9.3	7.3
PCE Deflator (1972 = 100)	165.1	169.0	**163.3**	**8.9**	174.0	179.4	184.5	189.1	**181.7**	**11.3**	193.6	197.5
% Change, Annual Rates	9.8	9.8	**8.9**		12.4	12.9	11.8	10.5	**11.3**		9.9	8.2
Consumer Price Index (1967 = 100)	220.8	228.0	**217.6**	**11.3**	237.1	246.8	254.9	260.6	**249.8**	**14.8**	266.3	271.7
% Change, Annual Rates	13.4	13.6	**11.3**		16.9	17.4	13.8	9.3	**14.8**		9.0	8.5
Total Personal Income	1946.6	2005.0	**1924.2**	**12.0**	2056.6	2106.4	2156.2	2199.8	**2129.7**	**10.7**	2234.8	2275.9
Disposable Personal Income	1640.0	1683.1	**1624.3**	**11.4**	1736.5	1776.8	1819.9	1854.9	**1797.0**	**10.6**	1879.8	1912.3
Savings Rate	4.3	3.5	**4.5**		3.4	3.4	3.2	2.8	**3.2**		2.6	2.6
Employment Rate	58.4	58.4	**58.3**		58.3	58.0	57.8	57.6	**58.0**		57.4	57.3
Unemployment Rate	5.8	5.9	**5.8**		6.1	6.6	7.0	7.4	**6.8**		7.9	8.2
Indus. Production (1967 = 100)	152.3	152.2	**152.1**	**4.1**	152.1	148.0	145.1	144.2	**147.3**	**−3.2**	142.9	143.0
Housing Starts (000)	1808.7	1593.3	**1721.9**	**−14.3**	1264.0	853.4	750.3	900.0	**941.9**	**−45.3**	1000.4	1101.4
Domestic Auto Sales (000)	8633.3	7500.0	**8375.0**	**−9.9**	7935.7	6040.1	7299.8	7475.8	**7187.8**	**−14.2**	7470.6	7595.2
Corporate Pre-Tax Profits	242.3	243.0	**236.6**	**14.9**	260.4	245.0	231.6	222.5	**239.9**	**1.4**	210.8	210.2
− Taxes	94.0	96.1	**92.5**	**9.5**	103.4	97.4	92.1	88.5	**95.3**	**3.0**	83.9	83.7
Net Profits	148.3	146.9	**144.1**	**18.6**	156.9	147.6	139.5	134.0	**144.5**	**0.3**	126.9	126.5
− Dividend Payments	52.8	54.4	**52.8**	**11.9**	56.7	58.8	60.7	62.1	**59.6**	**12.9**	63.2	64.0
Undistributed Profits	95.5	92.5	**91.4**	**22.9**	100.2	88.8	78.9	71.9	**84.9**	**−7.0**	63.7	62.5
+ Depreciation	132.8	135.2	**131.0**	**9.3**	137.4	141.7	146.1	150.5	**143.9**	**9.9**	155.3	159.8
− Inventory Profits	44.0	46.5	**41.8**	**65.7**	63.7	63.6	59.6	57.0	**61.0**	**46.1**	54.2	50.6
Net Cash Flow	184.3	181.2	**180.6**	**6.9**	173.9	166.9	165.3	165.3	**167.9**	**−7.0**	164.8	171.8

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